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New York Federal Court Allows Discovery of Reinsurer's Handling of Similar Claims

A federal magistrate judge recently granted, in part, a cedent's motion to compel discovery from a reinsurer regarding the reinsurer's handling of similar claims submitted to it by other cedents. *Zurich Am. Ins. Co. v. Ace Am. Reinsurance Co.*, No. 05 Civ. 9170 RMB JMF, 2006 WL 3771090 (S.D.N.Y. Dec. 22, 2006).

In this suit, the cedent alleged that the reinsurer had breached the duty of utmost good faith by failing to pay its full share of a settlement between the cedent and an original insured. The reinsurer countered that the cedent had unreasonably allocated policy limits to the loss.

The cedent alleged that the reinsurer's denial was "part of a pattern of conduct by [the reinsurer] to deny payment to its reinsureds based on artificial disputes concerning allocation." The cedent sought production of documents relating to two lawsuits in which the reinsurer was found to have wrongly denied payment to a cedent. The cedent also sought production of "all documents relating to any claims denied by [the reinsurer] on the basis of allocation."

The court held that the requested documents were relevant and discoverable. The court reasoned that discovery of the reinsurer's handling of similar claims "can provide evidence of how [the reinsurer] has interpreted its obligation to follow the settlements of its cedent in similar circumstances."

The reinsurer objected to the discovery on the grounds that it was unduly burdensome. It submitted an affidavit to the court stating that its computer system was incapable of segregating claims by the amount of the claim, the type of the claim, or the reason the claim had been denied.

The court responded: "A sophisticated reinsurer that operates a multimillion dollar business is entitled to little sympathy for utilizing an opaque data storage system, particularly when, by the nature of its business, it can reasonably anticipate frequent litigation."

In view of the computer system's limitations, the court ordered that the parties propose a protocol for sampling the reinsurer's claim files to obtain examples of claim files in which the reinsurer had addressed allocation of policy limits. The court permitted the cedent to take

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New York Federal Court Vacates Arbitration Award of Costs and Attorneys Fees

The United States District Court for the Southern District of New York has vacated an arbitration panel's award of attorney and arbitrator fees, holding that the reinsurance contract prohibited such an award. See *Reliastar Life Ins. Co. v. EMC Nat'l Life Ins. Co.*, No. 06 Civ. 10186 (LAK) 2007 U.S. Dist. LEXIS 9861 (S.D.N.Y. Feb. 13, 2007).

In *Reliastar*, the cedent and its reinsurer had arbitrated the scope of the reinsurer's obligations under certain reinsurance agreements. The arbitration panel granted the cedent its attorney and arbitrator fees, based on a finding that the conduct of reinsurer was lacking in good faith. The cedent moved to confirm the award, and the reinsurer moved to vacate the part of

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the depositions of the reinsurer's employees who were familiar with the reinsurer's data storage system.

The court cautioned, however, that "motive is generally irrelevant in breach of contract actions" and therefore, "similar acts' evidence is largely immaterial in such cases." "Whether [the reinsurer] has breached its contractual obligations depends on whether it has failed to 'follow the fortunes' or 'follow the settlements' of its cedent as those terms are used in the relevant policies, not whether it has breached its obligations under other policies."

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the award that granted the cedent its attorney and arbitrator fees.

The reinsurance agreements provided "[e]ach party shall bear the expense of its own arbitrator . . . and related outside attorneys' fees, and shall jointly and equally bear with the other party the expenses of the third arbitrator." The cedent argued that the award of attorney and arbitrator fees should be upheld regardless of this provision because it merely stated a general rule, but the reinsurance agreements also adopted New York law which would permit an award of attorneys' fees where a policyholder successfully brings an action against its insurer for coverage. The cedent also argued that

the availability of attorney and arbitrator fees was a matter for the arbitration panel and not the court.

The court rejected the cedent's arguments and ruled that the cedent was not entitled to attorney or arbitrator fees. It held that the contract was explicit in requiring that the parties bear their own attorney and arbitrator fees and the contract controlled. It also reasoned that, although "any ambiguities as to the scope of the parties' submission to arbitration are for resolution by arbitrators" is a broad principle, it is not boundless. As such, the court held that the arbitration clause was not so broad as to cover the award of attorney and arbitrator fees.

California Appellate Court Holds That Cedent's Attorney Owes No Duty of Care to Reinsurer

A California appellate court has held that a law firm retained by a cedent did not owe a duty of care to the reinsurer even though the reinsurer was potentially 100% responsible for the law firm's fees. *Zenith Ins. Co. v. Cozen O'Connor*, No. B184684, 2007 Cal. App. LEXIS 402 (Cal. Ct. App. March 21, 2007).

In this action, the cedent retained a law firm to represent it in an underlying environmental pollution coverage matter involving multiple locations and parties. The cedent did not seek contribution claims against twenty-two (22) responsible parties and their carriers because the law firm had ethical conflicts of interest with these other parties. Upon learning of the reason why contribution claims had not been brought, the reinsurer demanded that the cedent assert contribution claims against these parties with different counsel. The cedent asserted the contribution claims but the claims were untimely. The reinsurer then brought suit against the cedent for breach of contract and against the law firm for professional negligence.

The reinsurer conceded that it did not have an express agreement with the

law firm to receive legal services, but the reinsurer argued that an implied contract existed between it and the law firm. The reinsurer cited various facts in support of its contention: the reinsurer had reinsured 100% of the cedent's risk; some of the monies the reinsurer had already paid to the cedent included legal fees paid to the law firm; and the law firm reported case developments directly to the reinsurer. The court concluded that these facts did not create an implied attorney-client relationship between law firm and the reinsurer. The court reasoned that the cedent had exclusive control over the underlying claims, including the right to defend and settle, and the reinsurer had no right under the agreement to participate in the underlying claim. Therefore, the court held that no implied in-fact contract existed between the reinsurer and the law firm.

The appellate court also reviewed the reinsurer's contention that it was an intended third-party beneficiary of the legal services contract between the cedent and the law firm. The court concluded that neither the cedent nor the law firm intended for the firm's services to benefit the reinsurer. The

absence of this mutual intent requirement was dispositive against the reinsurer on its third-party beneficiary claim.

The appellate court reasoned that the cedent's and reinsurer's interests were not identical and, in fact, were potentially adverse. Because the cedent owed separate duties under the original insurance contract to its policyholder and it had exclusive control over how those duties would be discharged, any advice that the law firm provided to the cedent concerning coverage obligations for the underlying claim may be potentially adverse to the reinsurer. The court stated that, because the cedent, not the reinsurer, would be exposed to potential bad faith liability for an unjustified failure to fully discharge all of the obligations owed under the policy, the cedent's and reinsurer's interests were diverse. In the court's opinion, the law firm could not ethically represent both the cedent and the reinsurer in this matter, and therefore neither the cedent nor the law firm intended to confer third-party beneficiary status upon the reinsurer.

Arizona Federal Court Holds That Underlying Settlement Bars Cedent's Recovery Against Reinsurer

An Arizona federal district court has granted summary judgment to a reinsurer, holding that a settlement agreement between a cedent and a policyholder released the reinsurer's alleged contractual liabilities to the cedent. *Invitrogen Corp. and Kettlebrook Ins. Co. v. Employers Ins. Co. of Wausau a/k/a Employers Ins. of Wausau*, No. 06-0232, 2007 U.S. Dist. LEXIS 19301 (D. Ariz. March 16, 2007).

In this action, the cedent sought reinsurance payment for monies that it paid in 2003 to settle an underlying environmental coverage dispute with its policyholder, Invitrogen Corporation. Under this 2003 settlement agreement, the cedent agreed to release Invitrogen and its present or former subsidiaries. Both the cedent and Invitrogen agreed not to pursue any action in the future against each other relating in any way to the claims released in the settlement agreement. Apparently unknown to the cedent, the reinsurer was a subsidiary of Invitrogen at the time of the 2003 settlement agreement.

The cedent argued that the reinsurance contracts, not the 2003 settlement agreement, controlled and therefore the parties' dispute had to be submitted to arbitration pursuant to the reinsurance contracts. The reinsurance contracts called for arbitration when there is an "irreconcilable difference" between the parties as to the interpretation of the reinsurance contracts. The reinsurer countered that the 2003 settlement agreement, not the reinsurance contracts, controlled because the dispute concerned whether the 2003 settlement agreement released the cedent's right to collect under the reinsurance contracts.

The court rejected the cedent's position, and agreed with the reinsurer. The court held that the dispute did not concern irreconcilable differences as to the interpretation of the reinsurance contracts but rather concerned whether, under the terms of the 2003 settlement agreement, the cedent released the reinsurer as a subsidiary of Invitrogen. The court then ruled that the cedent

indeed had released its right to collect under the reinsurance contracts as part of the 2003 settlement between the parties. The court found that the settlement agreement was clear on its face that the agreement encompassed subsidiaries.

upon the plain language [of the settlement agreement], [the cedent] knew or should have known that the broad scope included [the reinsurer], an undisputed subsidiary of Invitrogen." The court further found that the 2003 settlement agreement's silence as to



The cedent argued that it should not be bound by the broad scope of the 2003 settlement agreement because at the time of the settlement it did not know that its reinsurer was a subsidiary of Invitrogen. The court rejected the cedent's argument because "based

reinsurance evidenced the parties' intent that the agreement be the final resolution of their dispute. The court granted summary judgment to the reinsurer on all the cedent's claims and, pursuant to the settlement agreement, awarded attorneys' fees to the reinsurer.

Illinois Federal Court Orders Bankruptcy Trustee to Sign Hold Harmless Agreement for Arbitration

An Illinois federal district court has ordered a bankruptcy trustee to sign a hold harmless agreement for the arbitration of an insurance dispute. In ordering the execution of a hold harmless agreement, the court rejected the bankruptcy trustee's argument that the agreement contravened his duties to the creditors of the bankruptcy estate. *Pacific Employers Ins. Co. v. Moglia*, No. 05 C 1366, 2007 WL 901889 (N.D. Ill. Mar. 27, 2007).

The bankruptcy trustee had brought an adversary proceeding against a workers' compensation insurer, claiming that the insurer had retained excessive collateral funds under a workers' compensation

insurance program with a now-insolvent insured. The insurance contract required that disputes relating to the insurance contract be resolved through arbitration in accordance with the Commercial Arbitration Rules of the American Arbitration Association. The bankruptcy court ordered the trustee and the insurer to arbitrate their dispute regarding the collateral funds.

Prior to the organizational meeting, the three-member arbitration panel requested that the parties execute a hold harmless agreement. The

trustee refused to sign the hold harmless agreement, and the arbitration panel refused to proceed with the arbitration. For more than three years, the arbitration stood at an impasse.

The trustee contended that the hold harmless agreement was against his better judgment as a bankruptcy trustee and was contrary to his duties to the bankruptcy estate's creditors. The federal district court saw the trustee's argument "as an end run around the key issue before this Court." According to the court, the key issue was "whether the Panel can properly call for the delivery of a hold harmless agreement under the AAA's Commercial Rules simpliciter."

The court ruled that the arbitration panel can require that the bankruptcy trustee sign the hold harmless agreement because the agreement served the purpose of the AAA's Commercial Arbitration Rules. "[T]he requested hold harmless agreement really codifies (or perhaps, more accurately, solidifies) the immunity accorded to arbitrators as a quasi-judicial body." The court further observed that Section 10 of the Federal Arbitration Act provided relief to the parties "against tainted arbitration decisions" without subjecting arbitrators to lawsuits. Accordingly, the court ordered the parties to sign the hold harmless agreement and "proceed with the long-delayed arbitration forthwith."

Oklahoma Law Prohibits Arbitrations of Reinsurance Disputes

Oklahoma adopted the Uniform Arbitration Act except for "contracts which reference insurance." Okla. Stat. tit. 12 § 1855(D) (2007). An Oklahoma federal district court recently ruled that this Oklahoma statute prohibits arbitrations of reinsurance disputes between cedents and reinsurers. *Mid-Continent Cas. Co. v. General Reinsurance Corp.*, No. 06-CV-0475-CVE-PJC, 2007 WL 539217 (N.D. Okla. Feb. 15, 2007). Accordingly, the court denied a reinsurer's motion to compel arbitration.

The court first addressed whether the Federal Arbitration Act (FAA) preempted Oklahoma Statute § 1855(D) or whether the McCarran-Ferguson Act saved this Oklahoma statute from federal preemption. According to the court, the FAA "create[s] a strong national policy in favor of enforcing agreements to arbitrate." The McCarran-Ferguson Act, however, provides that "No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance"

The court held that McCarran-Ferguson Act saved the Oklahoma statute from preemption by the FAA. "The Court would have to create a strained interpretation of section 1855(D) to conclude that this statute was not intended to regulate the business of insurance."

The court next addressed the reinsurer's argument that Section 1855(D) did not render the parties' arbitration agreement unenforceable. According to the reinsurer, Section 1855(D) merely removed the parties' arbitration agreement from the purview of the Uniform Arbitration Act and the state statute did not invalidate the arbitration agreement itself. The court rejected this argument, concluding that Oklahoma common law governs arbitration agreements that fall outside the Uniform Arbitration Act and that Oklahoma common law generally forbids voluntary arbitration agreements between private parties.

Neither party argued that another state's law governed the issue of the enforceability of the arbitration agreement. Consequently, this case did not present a choice of law issue.



Eighth Circuit Holds that Cedent May Proceed with Bad Faith Claim Against Reinsurer

The United States Court of Appeals for the Eighth Circuit recently held, under Missouri law, that a cedent had introduced sufficient evidence to proceed with its claim that its reinsurer had breached the covenant of good faith and fair dealing when the reinsurer cancelled the third year of a reinsurance contract. *See BJC Health Sys. v. Columbia Cas. Co.*, No. 06-1326, 2007 U.S. App. LEXIS 3915 (8th Cir. Feb. 23, 2007). The Eighth Circuit held that whether the reinsurer acted in bad faith was a jury question and reversed the district court's grant of summary judgment for the reinsurer.

The cedent, a captive insurer for a network of hospitals, entered into a three year reinsurance agreement. The reinsurance agreement had an "incurred loss condition" that provided that continued coverage would be conditioned upon an incurred loss ratio of less than 75%. The agreement also granted discretion to the reinsurer to calculate the loss ratio. Shortly before the beginning of the third year, the reinsurer notified the cedent that it would not continue the program because the cedent had exceeded the 75% incurred loss ratio.

The cedent brought suit for breach of contract asserting that the reinsurer had acted in bad faith in determining the incurred loss ratio and by failing to continue the program through the third year. The cedent introduced actuarial evidence that: (1) the reinsurer selected the same average experience ratio in various versions of its

actuarial analyses despite the fact that the underlying data had changed; (2) the reinsurer may have used more stringent actuarial assumptions and models in the third policy year; and (3) that the reinsurer was seeking to reduce its profile in the medical malpractice business, the type of business covered by the reinsurance contract.

The district court excluded the evidence that the reinsurer was seeking to reduce its profile in the medical malpractice business and granted the reinsurer's motion for summary judgment that it had not cancelled the agreement in bad faith. The Eighth Circuit reversed. It held that under Missouri law, while the reinsurer had discretion to calculate the loss ratio, that discretion was constrained by the covenant of good faith and fair dealing. Under this covenant, if a party can show that the other contracting party exercised its discretion in a way to "evade the spirit of the transaction" it may establish bad faith breach of contract.

The Eighth Circuit held that the district court should have allowed evidence that the reinsurer was seeking to reduce its profile in the medical malpractice business because this was evidence of an improper motive, which when taken with the other evidence, was sufficient to create a question of fact for a jury as to whether the reinsurer breached the covenant of good faith and fair dealing.

Contacts

McLean Office

1751 Pinnacle Drive
McLean, VA 22102

Walter J. Andrews

Partner
(703) 714-7642
wandrews@hunton.com

Lon A. Berk

Partner
(703) 714-7555
lberk@hunton.com

Paul Janaskie

Partner
(703) 714-7538
pjanaskie@hunton.com

Edward J. Grass

Partner
(703) 714-7649
egrass@hunton.com

Brian J. Gerling

(703) 714-7628
bgerling@hunton.com

Steven W. McNutt

(703) 714-7624
smcnutt@hunton.com

New York Office

200 Park Avenue
New York, NY 10166

Robert J. Morrow

Partner
(212) 309-1275
rmorrow@hunton.com

Hunton & Williams represents cedents and reinsurers in disputes involving reinsurance and advises clients on reinsurance issues. For more information about Hunton & Williams Insurance and Reinsurance Practice, please visit www.hunton.com.

McLean Office • 1751 Pinnacle Drive • Suite 1700,
Tysons Corner • McLean, VA 22102

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